

Answers to questions involving the tax exempt status of (1) hospitals that establish a cooperative hospital laundry service; and (2) a hospital which establishes its own laundry facilities and sells service to other hospitals.

The Internal Revenue Service has been asked a series of questions pertaining to the tax consequences of operating laundry services for hospitals. The questions and the answers are set forth below.

Section 501(c)(3) of the Internal Revenue Code of 1954 provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable, scientific, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 501(e) of the Code provides for exemption from Federal income tax of certain hospital service organizations organized and operated solely to perform specified services for member hospitals. Section 501(e)(1)(A) of the Code lists the specified services as data processing, purchasing, warehousing, billing and collection, food, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services.

Section 513 of the Code defines the term 'unrelated trade or business,' in the case of any organization subject to the tax imposed by section 511, as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purposes or function constituting the basis for its exemption under section 501.

Situation 1: A number of hospitals exempt from Federal income tax under section 501(c)(3) of the Code formed a laundry service organization. The organization was organized and operated on a cooperative basis to serve only the hospitals that organized it. All net earnings are required to be allocated or paid to patrons on the basis of services performed for them.

Question 1: Can the organization qualify for exemption from Federal income tax as a cooperative hospital service organization under section 501(c)(3) of the Code by reason of section 501(e)?

Answer: In order to qualify as a cooperative hospital service organization under the provisions of section 501(e) of the Code, an organization must be organized and operated solely to perform one or more of the services specified in section 501(e)(1)(A) of the Code. Since laundry services are not one of

the services specified in that section, the organization does not meet the requirements of section 501(e) of the Code, and thus is not exempt from Federal income tax under section 501(c)(3). See Rev. Rul. 69-160, C.B. 1969-1, 147. However, if all of the organization's net earnings derived from dealings with patrons are distributed or allocated pursuant to a pre-existing obligation to the patron hospitals within the time and manner prescribed for cooperative organizations in section 1381-83 of the Code, the organization would have no taxable income from such dealings.

Question 2: Would contributions by the member hospitals or other organizations exempt from Federal income tax under section 501(c)(3) of the Code to this laundry service organization affect the tax exempt status of the contributing organizations?

Answer: The service organization is entirely under the control of, and holds its property for the use of, hospitals that are exempt from Federal income tax under section 501(c)(3) of the Code. All funds contributed to the organization are therefore applied exclusively for the use of organizations exempt under section 501(c)(3) of the Code. For this reason, contributions to the laundry service organization by exempt organizations will not jeopardize the exemption of the contributing organizations. See Rev. Rul. 68-489, C.B. 1968-2, 210.

Question 3: Would the answer to question 2 be the same if a proprietary hospital, operated for profit, became a member of the service organization?

Answer: Although a hospital exempt under section 501(c)(3) of the Code could belong to a cooperative laundry service organization having nonexempt members without affecting its exempt status, its exemption might be adversely affected if the exempt hospital also made contributions to the laundry in excess of its proportionate share based on benefits to be derived. Any contributions made by the exempt hospital under these circumstances might inure to the benefit of the proprietary hospital and therefore would not be an expenditure in furtherance of an exempt purpose. Similarly, a contribution by any other exempt organization might also inure to the benefit of the proprietary hospital and adversely affect the contributing organization's exempt status.

Situation 2: A hospital exempt from Federal income tax under section 501(c)(3) of the Code established its own laundry facility. However, in addition to providing for its own laundry services, the hospital also provides laundry services to other hospitals that are also exempt under section 501(c)(3) of the Code.

Question 1: Does the sale of laundry services to other exempt hospitals affect the hospital's exempt status under section 501(c)(3) of the Code or the exempt status of organizations making contributions to the hospital?

Answer: The sale of laundry services to other hospitals is not an activity substantially related to the performance of the selling hospital's exempt purposes. Therefore, such activity would be unrelated trade or business within the meaning of section 513 of the Code and any profits derived would be subject to the unrelated business income tax imposed by section 511. However, the exempt status of the operating hospital or the contributing organizations would not be affected.

Question 2: If the hospital provided laundry services to a proprietary hospital, would its exemption be affected?

Answer: If the hospital provided services to a proprietary hospital above cost, such activity would have no effect upon its exemption or that of its contributors. However, if it provided laundry services to proprietary hospitals at less than cost, its exempt status might be affected because such services would not be in furtherance of an exempt purpose.